Financing a Small Business

Alberta
ECONOMIC DEVELOPMENT AND TRADE
Small Business Division

87-03795/

The competitive nature of our economy and the fast pace at which business conditions develop require that entrepreneurs have more capital and more sophisticated management skills than ever before. The new businessman will find that many decisions require technical knowledge beyond his own area of expertise. Often he will need the advice of specialists such as accountants, lawyers, insurance brokers and bankers. This handbook does not take the place of experts, rather it highlights some of the more important financial considerations of which the businessman should be aware for the welfare of his business.

Almost every person owning or managing a small or medium-size business has at some time required financial help. One of the more important jobs for a businessman is to plan and obtain the necessary financing to enable him to establish the business, allow the business to continue its operation and to assist the business to grow.

To obtain financing that will be the most beneficial to his business, a businessman must first recognize the importance of good financial arrangements. He then must be aware of the different methods of financing a business and where the necessary funds are available. In order to convince lenders or investors to support his business, the businessman should undertake some method of financial planning to be able to approach them with an attractive proposal which will demonstrate the potential profitability of the business. A business plan is also invaluable to assist in organizing the business to ensure its survival.

"Financing a Small Business" is one of a series of booklets published by Alberta Economic Development and Trade, Small Business Division. Other booklets that may be useful are:

- Starting a Small Business
- Marketing for a Small Business
- Operating a Small Retail Business
- Operating a Small Manufacturing Business
- Operating a Small Service Business
- Selecting a Small Business Computer System
- Bookkeeping for a Small Business
- Operating a Small Construction Business

These publications are available at all Economic Development and Trade offices listed in the back of this publication.

NUMBER TWO OF A
SERIES COURTESY OF:

Alberta
ECONOMIC DEVELOPMENT AND TRADE
SMALL BUSINESS DIVISION

March 1987 — Tenth Printing
Communications 8601 40M
ISBN 0 88669 0110

PREFACE

CHAPTER 1 METHODS OF FINANCING A BUSINESS 1

EQUITY FINANCING
- Type of Business Organization Affects Financing
- Going Public
- Venture Capital

DEBT FINANCING
- Fixed Assets Financing
- Conditional Sales Purchases
- Leasing
- Whether to Lease or Purchase
- Sale-Leaseback
- Financing Working Capital
- Line of Credit (Demand Loans)
- Character Loans
- Commercial Loans
- Accounts Receivable Financing
- Factoring
- Inventory Financing

CHAPTER 2 INTERNAL FINANCING 12
- Receivables
- Inventory
- Supplier Credit
- Prepayments and Employees as a Source of Financing

CHAPTER 3 APPROACHING LENDERS 15
- Dealing with your Banker as a Financial Partner
- Banking Strategy Questions
- Selecting the Right Bank
- Understanding the Loan Process
- Recognizing Your Job

CHAPTER 4 FINANCIAL PLANNING 20
- Elements of a Financial Plan for Lenders or Investors and You
- Business Planning
- Start-up Costs
- Cash Flows
- How to Prepare a Cash Flow
- Break Even Analysis
- Ratio Analysis

APPENDIX METHODS AND SOURCES OF FINANCING A BUSINESS 35
Methods of Financing a Business
Sources of Financing a Business
Provincial Crown Agencies Authorized to Provide Funds to Alberta Business
Federal Crown Agencies and Other Funding Sources

ALBERTA ECONOMIC DEVELOPMENT AND TRADE OFFICES 41

Essentially, there are two methods of financing a business. These are equity financing and debt financing. There are other sources of money available to a business such as trade credit and the prepayment of goods or services, but for most businesses their principal source of funds is through equity or debt.

EQUITY FINANCING

Equity is the amount of money that is put into the business other than from outside loans. The most obvious source of equity financing is the individual starting the business. The equity may come from personal savings, securities, sale of real estate, or relatives, but it is put up by the individual or persons who will have ownership of the business.

Many people have the mistaken impression that financial institutions, or government agencies, will provide all or most of the basic capital required for a business venture. In fact, the entrepreneur himself must assume the bulk of the risk and does so by committing his funds to the business. The amount of equity investment required varies widely, depending upon the kind of business, experience of the owners, current economic prospects, etc.

TYPE OF BUSINESS ORGANIZATION AFFECTS FINANCING

In Alberta there a number of different forms of business organizations which can influence the way equity is put into a business.[1]

The simplest type of business organization is a sole proprietorship. In a sole proprietorship, the owner supplies the money necessary to fund the business. He owns all the assets and is responsible for all the liabilities. If the owner cannot supply all the equity capital needed, he may have to find one or more partners willing to put money into the venture. Obtaining a partner means that the ownership will be shared as well as the liabilities. In a partnership, each partner can be held personally responsible for obligations placed on behalf of the business by other partners.

Sometimes the partner is "silent" which means he will help supply the capital while you supply the "know-how." In most cases, however, partners work together at the business. Ideally, in a working partnership, each partner will have skills different from the other so that both can contribute to the business in other ways besides supply money. Whether silent or active, your partner will usually insist on some share in the management decisions. There

---

[1] For a more complete description of the types of business formations refer to the handbook Starting a Small Business: distributed free of charge by the Alberta Economic Development and Trade, Small Business Division.

should be a word of caution here: you should be very careful in choosing a business partner. Many partnerships fail because the partners cannot get along.[2]

There is a special legal arrangement whereby a person may contribute financially but cannot be engaged in conducting the affairs of the partnership. This is called a "limited partnership." A limited partner is normally only liable to the firm or its creditors to the extent of the capital he has agreed to contribute towards the partnership. To remain a limited partner, a person must take no part in the management of the firm, nor may he act on behalf of the company, or he becomes a general partner.

Lastly, a limited company can be formed where ownership is shared, generally in proportion to the amount of money each person puts up. If you decide to form a limited company, it can be advantageous to buy only one or two shares of the company and then lend the rest of the money to the company in the form of "shareholders' loans." The reasons for this are:

(1) If you purchase shares in the company, the only method of withdrawing your investment from the limited company is by paying yourself wages (which are taxable) or by dividends (which are also taxable). On the other hand, putting money into the company by means of shareholders' loans means that you can take this money out of the company without tax.
(2) Interest on shareholders' loans paid to you by the company is tax deductible by the company.
(3) Lenders consider shareholders' loans as equity as long as they are left in the company.
(4) It is easier to repay a loan than sell shares back to the company or to other investors.

In attempting to attract partners or other equity investors, newer and smaller business must be able to demonstrate the profitability of the venture. Investors can obtain returns of up to and sometimes exceeding 10% with relatively safe investments in mortgages and bonds. Therefore, in order to invest in your enterprise, which probably carries a greater degree of risk than mortgages, the business must promise better financial returns. Investors must be convinced that the payoffs will be attractive and the risks minimal. One method of doing this is with a well-documented business plan as given in the chapter on financial planning in this handbook.

---

[2] When entering into a partnership, an agreement should be drawn up between the partners to protect their interests. The type of subjects to be addressed in the agreement are given in the handbook "Starting a Small Business."

GOING PUBLIC

Another method of obtaining equity financing is to offer shares in the business for sale to the general public. A limited company may remain private if it does not have more than 50 shareholders and does not sell its shares or securities to the public. Therefore, equity financing for a private company is usually obtained from a limited number of individuals who are actively interested in the success of the enterprise. Public companies, on the other hand, provide the greatest opportunity for obtaining equity capital since they can sell their shares to anyone.

In certain cases, a private company can make representation to people not directly associated with the principals of the business to purchase shares of the company. However, proper authorization must first be obtained from the Alberta Securities Commission.[3] This regulation is necessary to protect the public from fraud.

Going public (becoming a public limited company) or offering shares to the public at large can be a complicated procedure. A detailed prospectus of the company's operations must be filed with the Alberta Securities Commission. The road to going public can often be long (from three to six months) and expensive ($25,000 at the minimum). Because of the expense involved, few investment dealers would consider undertaking a public issue of securities much below $500,000. Nevertheless when companies become sufficiently large and profitable, a public offering of shares can be an attractive alternative to obtain financing. To learn more of this method of financing a business, one should contact an established investment dealer.

VENTURE CAPITAL

In Canada, there are a number of venture capital firms that will supply money to fledgling businesses in return for equity participation (part ownership).[4] The venture capitalist will usually invest from $25,000 to $500,000 over the long term but expects good growth prospects. For new businesses, the venture capitalist would expect the value of the investment to increase tenfold over four years and for existing firms, a doubling of the investment value within four years. One Canadian venture capital firm has estimated that they only seriously consider one out of 10 proposals put before them and that, on the average, they only actually participate in about one out of 50 propositions.

---

[3] The Alberta Securities Commission is located on the 21st Floor, 10025 Jasper Avenue, Edmonton, Alberta T5J 3Z2, phone 427-5201.

[4] Venture capital information can be obtained from the Small Business Equity Corporations Program, Alberta Economic Development and Trade, 10025 Jasper Avenue, Edmonton, Alberta T5J 3Z3, phone 422-5025.

Besides fast growth prospects, the venture capitalist looks for sound management and a high degree of financial commitment on the part of the individual seeking financing. Most venture capital firms do not wish to become involved in the day-to-day operations of the businesses in which they invest. They will require representation on the board of directors of the companies and, in some cases, will seek majority control, depending upon their equity participation. Generally a role of continuing counselling develops between management and the venture capitalist.

The goal of the venture capitalists is to provide equity financing for what are usually risk enterprises with potential. Most investments by Canadian venture capitalists are in the expansion of established companies rather than start-up situations. Their hope is that within five to 10 years, they will be able to liquidate all or part of their investment at a substantial gain. Venture capitalists are "hard-nosed" professionals and will attempt to drive the best bargain they can achieve. A businessman seeking venture capital participation should be sure of his approach and be able to substantiate his business claims.

In special circumstances, the Federal Business Development Bank will consider equity participation in Canadian firms in conjunction with a term loan secured by the fixed assets of the business. They also provide an equity matching service.

Whether it is a case of bringing in a partner, a venture capitalist, or selling common stock to outside interests, it is important to recognize that selling equity in return for financing can be an expensive form of financing. If the company prospers because of the founder's hard work, it is sometimes difficult to accept the rewards going to others because of a financial commitment made some time ago. Before approaching investors, an entrepreneur should first exhaust those sources of funds which do not involve a loss of ownership, such as his own personal resources, and debt financing.

DEBT FINANCING

Most firms borrow money to transact their affairs. There are a number of sources that will lend money to businesses in Alberta as given in the "Sources of Financing" in this handbook. Entrepreneurs should attempt to familiarize themselves with the lender's requirements and determine which type of borrowing is most suitable for their business.

One cardinal rule of finance should be observed, that is, long-term use of funds should be supplied from long-term sources of funds. In other words, avoid imbalance in financing. Long-term debt financing should not be used for short-term working capital and, conversely, working capital should not be used to finance long-term fixed assets.

For example, one Alberta manufacturing company was almost forced into bankruptcy even though they were showing good profit

on their accounting records. The firm had obtained a working "line of credit" with a bank for $50,000, but had used this money to purchase fixed equipment. Because of this management decision, they were unable to meet their accounts payable, purchase needed inventory, or meet other operating expenses. The business was eventually forced into liquidating most of its equipment at a fraction of its original cost in order to keep operating. This company should either have leased the equipment or obtained a term loan over some years to purchase the equipment so that working capital could have been used for current operating expenses.

A new business usually does well to minimize its fixed capital outlays to the greatest extent possible. For example, rent real estate rather than buy it and lease equipment instead of purchasing it. Although this policy may appear more expensive over the long run, it means that the firm will have more money available for current expenses. After the company has established itself as a continuing profitable entity, any lack of economy in these practices can be cured. Equity capital used for working capital can normally be recaptured quickly through inventory turnover. However, equity capital sunk in fixed capital is harder to retrieve. One of the main strategies to cope with business uncertainty is to reduce fixed costs even if this considerably increases variable costs.

Many businesses fail because they simply run out of money as they purchased items they could have financed, thereby leaving themselves short of equity operating funds.

FIXED ASSETS FINANCING

It is useful to think of business credit as being divided into two categories, one concerned with medium and long-term credit of more than one year, and the other with short-term credit of one year or less. The fixed assets of a business, i.e. those having a life of more than one year, are ordinarily financed from equity capital contributed by the owner or by medium or long-term loans having a duration related to the expected life of the assets.

One method of obtaining fixed asset financing is to negotiate a "term loan." A term loan is a business loan which has a maturity of not less than one year and usually does not go beyond 15 years. The security offered for repayment is normally a form of mortgage against the equipment or other property being financed. The length of the repayment schedule is generally related to the useful life of the asset. The lender will only give a percentage of the value of the asset being purchased. For example, a bank may lend up to 75% of the value of a truck to be repaid within five years, whereas the same bank may lend up to 80% for a building to be repaid within 12 years. The balance of the money owing for the assets would come from the equity the owner contributes.

The advantage of a term loan is that the terms, including repayment schedules, can be negotiated between the lender and

borrower. The loan agreement is based upon the ability of the borrower to repay the loan out of earnings, generally in installments. As long as the borrower complies with the terms of the loan, he has assurance that no payments other than regular installments will be required prior to the due date of the loan. There is the added advantage that the lender and borrower develop a relationship over a relatively long period of time and that the lender can be of assistance in advising on financial matters and perhaps be able to offer additional financial assistance.

When lending on a medium or long-term basis, credit institutions tend to place emphasis on the earning power of the business over a period of years and on its ability to repay the debt. The businessman must, therefore, convince the lenders that the business is sound, preferably by the use of a business plan.

One of the more important indicators used by lenders to demonstrate the soundness of the business' financial position, is the debt-to-equity ratio. For example, if your business owes $4,000 to others and you have only a $2,000 investment in the business, then your debt-to-equity ratio is 2:1. Some lenders interpret this ratio differently, but for new businesses it is unlikely that the lender will go beyond 2:1 or even 1:1.

Another key indicator is the current ratio, the ratio of current assets to current debt. This is used as a measure of short-term solvency. For example, if your cash on hand and accounts receivable add up to $6,000 and your accounts payable are only $2,000, then your current ratio is 3:1, which is favourable. This demonstrates to lenders that your cash position is sound. Note that a higher debt-to-equity ratio is viewed less favourably and a higher current ratio is looked on more favourably.

If the loan is given to a limited company, the lender may require your personal guarantee. In other words, you agree that if the company cannot repay the loan, you will. This guarantee may be limited or unlimited. a limited guarantee allows the lender to call upon you to repay the amount owing on that particular loan. An unlimited guarantee allows the lender to call upon you to repay all funds borrowed by the company from that institution, including all other loans, overdrafts, etc. It is to your advantage to negotiate a limited guarantee — say the amount of the loan plus three months' interest. Once you have repaid the loan, be sure to obtain a release of the guarantee.

The lender may request a "Postponement of Claim" whereby the company agrees not to repay shareholders' loans until the lender has been repaid in full. It is also not unusual for the lender to request "Key Man Insurance" where key management personnel obtain life insurance assigned to the lender. If a lender requests "Key Man Insurance" be sure to obtain a letter from him to this effect as the cost of the premium can be used as a business expense for tax purposes.

CONDITIONAL SALES PURCHASES

In many cases, manufacturers of new equipment will assist in financing purchase of their equipment through the use of conditional sales purchases. The manufacturer will take the purchaser's note after a down payment of one-quarter to one-third of the purchase price. The ownership of the property under such an arrangement is retained by the seller until the buyer has made all the required monthly or quarterly payments over the term of the contract.

LEASING

More and more businessmen are using leasing as a means to finance the use of equipment without large capital expenditures. A company can acquire the use of equipment by merely committing itself to pay a number of rentals without making a substantial cash payment or incurring a large obligation. The lease is usually written on the total customer selling price and is drawn for a period of usually three to five years. The total amount to be paid is computed by adding finance charges to the total customer selling price.

Because leasing is becoming more common as an alternate form of financing in business, the following should be considered:

(1) When To Lease
When encountering rapid expansion and need all available working capital to increase inventories, plant facilities, etc.
When high capital requirements for new equipment are necessary and there is little or no cash available.
When equipment needs replacement, often because of technological advances in an industry.

(2) Factors To Consider When Deciding Whether To Buy Or Lease
Terms of the lease contract.
Probable lifespan of the machine.
Servicing of the equipment.
Original cost of the machine versus lease cost.
Depreciation versus lease expenses deductability.
Salvage value.

(3) The Lease Contract — Terms and Constraints
Length of the lease.
Personal guarantee as well as company guarantee.
Cancellation terms if applicable.
The value of leased equipment for insurance and termination purposes.
Arrangements for return, renewal, or purchase of equipment upon lease expiry.
Determination of who is responsible for paying any applicable taxes, insurance and maintenance.
Number, size and dates of lease equipment.
Other specified terms and conditions such as payment of legal fees, administrative and clerical costs and financing costs.

(4) Factors Affecting The Leasing Payment
The lessee's credit standing.
The length of the lease.
What type of equipment is leased and how it will be used.
The residual value.

WHETHER TO LEASE OR PURCHASE

When trying to determine if it would be more beneficial for your business to lease or buy equipment, it would be wise to consult your accountant. In order to do a complete job of weighing alternatives, you should do an after-tax, present-value comparison. What this means is that you determine the true cash outflow by deducting from the base payments the amount of tax savings (in most cases 20%), and then discounting the cash flows by a present value factor.

Let's say you could lease a vehicle for $7,050 per year, for five years. Your actual cash outflow would be $7,050 minus the 20% tax rate ($1,410) or $5,640.

The alternative is to borrow money to purchase the asset. This same asset could be bought for $24,000. Let's assume you could borrow at 18% with payments over five years. The interest paid plus the depreciation are tax deductions which will save cash flow by reducing taxes. Add the annual depreciation ($4,800) plus interest.

$\left(\frac{24,000}{2} \times .18 = 2,160\right)$, then multiply by the rate

$(4,800 + 2,160 \times .20)$ giving a tax shield of $1,392.

Loan payments would be $7,675. Thus the cash outflow per year would be minus the tax shield of $1,392 for a net figure of $6,283.

In this example, leasing alternative means an annual cash outflow of $5,640, while purchasing has a cash outflow of $6,283. Each situation will be different in the terms of lease payment, loan payment, and a key component we ignored in this example, namely, the anticipated salvage value of the asset.

Accountants might apply the theory of present value to the cash flows and come up with a more theoretically correct answer. For most purposes, however, average cash flows will suffice.

Leasing offers your business a number of advantages.

(1) If land is leased, it provides, in effect, depreciation which is prohibited under purchase.
(2) Generally it will have a positive effect in a firm's financial ratios.
(3) Liquidity may be increased if an existing asset is sold and the cash used for working capital. The asset you sold is replaced by a leased unit.

(4) You obtain 100% financing.
(5) Lack of restrictive covenants from lenders.

But there are some disadvantages to leasing:

(1) High interest costs.
(2) Lack of salvage value.
(3) Difficulty of property improvements.
(4) You may have to make payments on obsolescent items.

Each proposal must be looked at carefully, and each decision is independent. Next time you lease or purchase, think about the alternatives and pick the one most advantageous to you. The more you look into it, the more knowledge you will have about what makes your business tick.

SALE-LEASEBACK

Sale-leaseback arrangements have also become increasingly popular in recent years. By this method of financing, a company sells an asset to an insurance company or other institution and then immediately leases it back. Here again, the lessee obtains working capital and rental payments can be charged as an expense for tax purposes. The sale-leaseback arrangement makes it possible for the seller to borrow more money than he might have been able to if the businessman held encumbered property. Leases are generally long-term and the good credit standing of the lessee is important. For new businessmen, leasing can be advantageous in that equity capital can remain intact for operating expenses.

FINANCING WORKING CAPITAL

Obtaining sufficient working capital is frequently cited as one of the more difficult problems facing the small businessman. Retail stores can be especially hard pressed in this regard. However, there are a number of methods by which operating money can be obtained through debt financing.

LINE OF CREDIT (Demand Loans)

A line of credit is provided by banks to support working capital required by the business. The bank will negotiate to lend up to a certain amount of money providing certain terms and conditions are met. The bank can cancel the line at any time it considers necessary (hence the name "demand loan"). However, it will not generally cancel without cause. A line of credit is extremely useful to a businessman. The loan will go up and down as the business needs the money and interest is paid only on the amount outstanding. Generally, it is wise to avoid continuous operation at the upper end of the credit line.

CHARACTER LOANS

Character loans are given to individuals or companies with excellent credit ratings. They are generally unsecured loans made for the short term to be used for general purposes.

COMMERCIAL LOANS

These are self-liquidating loans made for the short term (30 to 90 days). They are generally used for such things as seasonal financing or for inventory purchases.

ACCOUNTS RECEIVABLE FINANCING

In accounts receivable financing, lenders make cash advances to borrowers using accounts receivable as security. There are two methods by which this is accomplished. In the first method, the borrower's customers are asked to remit payment directly to the lender. This arrangement is generally not desirable as it could upset the relationship between the borrower and his customers. In the second method, the borrower receives payment from his customers and remits the total payment intact to the lender. The lender will release the borrower's indebtedness and return any excess payments after deducting finance charges.

With accounts receivable financing, the borrower is able to secure a continuous source of operating cash without entering into long-term financing arrangements. The relationship with the finance company can develop into a continual arrangement whereby up to 80% of the assigned accounts can be financed. It is important to recognize, however, that the borrower is still responsible for collecting the accounts receivable.

Alberta manufacturers or processors who encounter difficulty in financing export orders are advised to contact Alberta Economic Development and Trade, for information on the Alberta Exporters Guarantee Program.

FACTORING

Factors are companies involved in purchasing outright the accounts receivable of their clients. It usually means a continuous agreement whereby the factor is responsible for granting credit to the business customers, performing the accounts receivable bookkeeping and collecting the accounts. In other words, the factor assumes all risks in regard to granting credit and collections. Generally cash is made available to the client on the collection date of the goods sold.

To do business with a factor, the volume of business should be sizeable (about $250,000); the prospective client should sell on normal credit terms and the majority of its customers should have good credit ratings.

Factoring companies offer an important service to the Canadian businessman. Generally, they service manufacturers and wholesalers engaged in the production and selling of items for which there is a continuing or repeat business such as shoes, textiles, various manufactured items, and even certain types of raw materials such as lumber and building supplies. There is an increasing trend by Canadian companies in the export field to make use of the services available from factoring companies.

The factor charges interest on the receivables discounted, plus a commission. This commission is the factor's fee for assuming full credit risks on the receivables purchased as well as for undertaking the collection work.

INVENTORY FINANCING

For some established firms, inventory will be financed by banks or commercial finance companies up to 75% of the value for both raw materials, work in progress and finished goods. Section 88 of the Bank Act enables chartered banks operating under the Bank Act to lend against security consisting of products of the mine, forest or stream. However, in most cases of inventory financing, good rapport has been established over a period of time between the lender and the borrower. For new business, inventory financing can be difficult to obtain.

Retail stores and other businesses which require large amounts of unsold inventory often experience difficulty at the outset in obtaining inventory financing. This is because retail stores have a high failure rate and lenders do not appreciate merchandise such as clothing, toys, etc. as security. In most cases, when inventory advances are made, there must be a ready market for the goods in question and they should not be perishable or subject to early obsolescence.

It is incumbent upon the businessman to establish a good relationship with lenders that could support the business. When it is recognized that there will be some financing requirements, steps should be taken early to contact lenders so that the proper arrangements can be made when they are needed.

Many businessmen seeking money from outside their company are actually in a position to obtain the money they require from a most ideal source — their own resources.

RECEIVABLES

One obvious source is accounts receivable. A business needs sufficient capital to meet its current commitments but if money is tied up in receivables, the business can be irreparably harmed. The problem can be particularly noticeable in a growing firm with expanding sales. There is a tendency for receivables to increase at the expense of cash, inventories and, finally, fixed assets. Unless receivables can be converted into cash in a minimum period of time, the business firm will lose its liquidity, exhaust its credit and find its growth potential limited. Receivables can be reduced by better credit policies, better policing of credit or by more diligent collection policies.

The granting of credit can often lead to a precarious situation for a business. Many businesses have failed because of bad debts. There would be fewer bad debts and overdue accounts if more attention were paid to the initial granting of credit. Businessmen should not blind themselves to the difficulty of collection because of the prospect of a good sale.

A good accounting system is crucial to controlling accounts receivable. Accounts should be regularly aged and overdue payments immediately flagged for attention and action.

Some businesses post and balance customer accounts on a current basis, thereby allowing them to send out statements to customers early in the month. Other businesses rely on service bureaus for collection but one should be aware of the costs involved. It is important to recognize that the quicker receivables are turned into cash, the more current money the firm has available with which to work.

INVENTORY

Inventory management should be given greater attention by small businesses. A business may have considerable amounts of money tied up in inventory either of raw materials, work in process, or in finished goods. For some organizations, the carrying cost of inventory exceeds 30% per annum. For manufacturers, inventories should be kept to the minimum, given changing business circumstances. For retailers/wholesalers, their business depend upon inventory turnover.

If finished goods inventories are considered to be excessive, perhaps they could be reduced by offering cash discounts, by extended repayment terms or by aggressive advertising tactics. These actions could result in bringing current cash into the company. Care should be taken in reducing prices as it could lead to the alienation of customers when price levels are restored.

In purchasing inventory, the businessman should attempt to maximize his return on investment. A business must be careful of its purchasing policies at all times. Many businesses have failed because too much inventory has been bought, thereby limiting the amount of working capital needed to carry on the business. This is especially true for slow moving items.

For manufacturers and processors good co-ordination is required between production and sales. It is costly to maintain inventories for sales expected many months in the future. Once again, the importance of a business plan or budget cannot be overemphasized.

SUPPLIER CREDIT

Often businesses can benefit from credit obtained from suppliers. Under competitive pressure, suppliers may be prepared to provide financing, not only through special or extended terms but also through direct debt or equity investment. A word of caution, however, a business can become too firmly attached to a particular supplier because of significant credit assistance. This could lead to the situation where the business will have to continue to purchase from the supplier, even if the supplier ceases to be competitive in terms of price, quality, delivery, and service. Good credit terms from suppliers can come about as a result of careful, tactful negotiation by the buyer.

Some businesses obtain credit by delaying the payment of their bills. Some of the most respected businesses in the world use this tactic but, sooner or later, a firm could run the risk of losing the goodwill of its suppliers. Habitually poor bill payers can expect their suppliers to impose stringent credit conditions to the extent of asking for prepayment of goods or services.

A new small business can expect suppliers to be very careful about granting trade credit. The best policy is a frank discussion with suppliers about the terms they are willing to extend and full disclosure of financial plans. A small business with good equity capital and managed by a person who shows an awareness of financial management can usually get fair accommodation from the beginning. As the business' creditability with suppliers grows, extended terms can be negotiated. However, a small business sooner or later should demonstrate its ability to pay early and promptly.

PREPAYMENTS AND EMPLOYEES AS A SOURCE OF FINANCING

In some cases, a business can encourage its customers to make payments prior to production or delivery of the goods or services. For example, mail order businesses generally ask for payment prior to forwarding their goods to the customer. Custom manufacturers also often ask for prepayment of goods. These prepayments may form a fairly permanent source of working capital. Sometimes special pricing and special terms may be necessary to attract prepayment deposits.

Another source of internal financing which may be available to an existing business is its employees. Employees with access to capital may be willing to invest in the company because they understand its products and trust the management. They are also in an advantageous position to closely monitor their investment. If an employee has a stake in the company's future, it could positively influence his working habits and concern for the company's success. On the other hand, because the employee has a share in the business, it could prove difficult to remove, retire, or replace him if he becomes unproductive or uncooperative.

Generally speaking, starting a new business is a risky endeavor and no one is more aware of this than a banker. If starting a new business is a risk, then financing a business facing current financial problems is even riskier. The lender must be convinced that the proposition is sound and profitable and that you have the ability to make a success of it.

DEALING WITH YOUR BANKER AS A FINANCIAL PARTNER

Most people are apprehensive about going to see their banker. There has always been a mystique about the banker and his industry. In reality though, the banker is no different than you. Both of you have the same goals - profit and success.

For your long-term success obtaining the appropriate bank credit at the right time is immensely important. Therefore, whether money is tight or loose; whether interest rates are high or low; it pays to cultivate a close relationship with your bank.

Plan for your requirements well ahead. It is important to approach your banker early. A lender does not want to be approached at the last minute with a crisis situation such as a payroll you are unable to meet. He often needs time to assess the proposal. Also it is often possible that the person dealing with you cannot approve the loan on his own.

Building a good working relationship with a bank is not always easy. Some people cannot understand why a bank will refuse to lend them money for business purposes or attach conditions which seem to be restrictive. If the bank does not lend you money, it is probably because it recognizes risks in your scheme which it is not prepared to accept. Thus, the bank could be indirectly looking after your better interests.

BANKING STRATEGY QUESTIONS

Before looking at how to develop this close relationship, two questions of banking strategies should be addressed. **The first question is** — should entrepreneurs use only their own money in a business venture? **The answer is** — borrow to get the business started, as long as the firm's cash flow is adequate to cover the payments for both principal and interest on the funds borrowed.

The money used to purchase the current and fixed assets of a small business comes from two sources: lenders and owners. It is recommended that a mix of both sources of funds be used. The money owed to lenders is called the borrowed capital or **debt capital**. The money invested by the owner is called the **equity capital** and the relationship between the two is called **the debt-to-equity ratio**.

One common error made by entrepreneurs is to borrow so much that the debt-to-equity ratio becomes dangerously high — too much money is owed for the amount of money invested by the owners.

The second question is — should the borrowed capital be repaid as fast as possible. **The answer is** — NO. Borrowed capital in a business should be used in the same way that materials, equipment and other assets are used. It should be noted, however, that it must be profitable to borrow. For example, if borrowed capital costs 15% per annum and can be used to earn 20%, then it is advantageous to borrow. If, on the other hand, the borrowed money costs 15% per annum but earnings are only 10%, then the rate of return on invested capital is in question.

SELECTING THE RIGHT BANK

The first step in developing a good financial partner relationship with a banker is finding the right bank for your business.

Some suggestions on how to find the right bank include the following:

1. Find out from the business community who they would recommend as a banker.
2. Find out which banks are knowledgeable of the industry you wish to pursue.
3. If possible, try to get an introduction to the banker.
4. Make sure to arrange for an appointment.
5. Keep your first meeting with the banker as brief as possible. Be prepared to make a verbal presentation based on the information you will be providing in your business plan. Your business plan, as a rule, will not be presented to your banker at this first meeting.
6. It is advisable to approach more than one lender but do not shop for a bank too extensively. It is time-consuming and most lenders work on the same principles.

UNDERSTANDING THE LOAN PROCESS

The next step towards a financial partner relationship is to understand the loan approval process and the banker's function in this process.

Borrowing from a bank is a contractual obligation. The banker provides the money and, in return, expects a number of things to take place. First, the banker expects the payment of interest and orderly reduction of capital, maintenance of any collateral possessions, and the provision of timely financial information. As a rule, these conditions or ground rules are set out by the banker prior to any funds being disbursed by the bank.

Many of the major commercial banks have streamlined their loan approval system to provide a faster reponse to the client. It must be pointed out, however, that the bank must be given sufficient information to prepare the credit application in detail. A well-prepared business plan will reduce the approval process considerably.

Earn your banker's respect by showing good faith. Build a reputation for integrity by conducting your banking affairs in a logical manner. Observe the banker's policies as this will assist in your relationship. Keep the banker informed of all developments within your business. When a problem occurs reasonable solutions can often be found if the businessman puts forward an honest front with a plan to tackle it.

As might be inferred, a banker sees himself as a "money doctor." He expects his clients (patients) to tell him everything that is needed for a proper diagnosis. Again, your business plan is a must to meet this need.

If a well-prepared business plan is presented to a commercial lending unit of a major bank you should expect the following turnaround time:

***Approval at the Following Levels**	**Average Turnaround Time**
Level (1) Account Manager	1 – 2 Days
Level (2) Unit Manager	1 Week
Level (3) Regional or Divisional Manager	2 – 3 Weeks
Level (4) Head Office Credit Unit	1 Month

* Each level will carry its own lending discretionary limit, i.e. if Level (2) has a discretionary limit of $200,000 and your application is for $250,000, your application would no doubt be handled by the first three levels in the approval process

Some things to remember when dealing with your bank and bankers:

1. Banking is a very personal business. You will have to develop a mutual trust.
2. Try to keep the banker informed about what is happening in your business — both good and bad. The banker doesn't like surprises! He will find out sooner or later that you may have been withholding information pertinent to your business. When this happens the relationship you have worked so hard to cultivate will quickly deteriorate.
3. Evaluate your banking relationship each year. An ideal time would be when you are preparing your yearly operational plan.
4. If you decide to change bankers, give yourself ample lead time.
5. If your bank manager gets transferred, don't try to follow. Make an appointment to meet with the new manager so you can get acquainted.
6. The majority of major chartered banks have created commercial banking centers. These banking units are staffed with seasoned commercial lenders. Because of this, borrowers should realize a much faster turnaround on loan requests. On

the other hand, the bankers now expect and require more professional loan presentations.

RECOGNIZING YOUR JOB

The final step towards developing a financial partner relationship is to know what your banker expects of you and what he needs. To build a good relationship with your banker and to use the banking system to your advantage, you must understand the system within which the bank operates.

All banks are in existence for one purpose — to make a profit — the same as you. The banks borrow money from one source and lend it to others. Their profit is the difference between the cost of borrowing and the rate at which they lend this money out to their clients. Whatever your relationship is with your banker, he works for a company that must make a profit and if he cannot justify the risk of a loan with the return, then there is no deal. If such is the case your job is to convince him otherwise.

It is the banker's duty to protect his shareholders' money and the investments of the bank's depositors by making only good loans — it is you who must persuade the banker that you (and your business) are a good risk. This is the way your banker will look at your company and your needs:

Security
- current assets (inventory and receivables) for short term
- fixed assets (land, buildings and equipment) for long term loans, i.e. two to 10 years
- personal guarantees, if a shortfall

Liquidity
- your ability to pay interest and pay down — on time

Past Performance
- profits
- keeping your promise
- being on time
- reliability

The Company and Its Stability
- retained earnings — company profits
- paid in capital — your equity
- dividends (do not milk the company)

Your Own Reputation and Ability
- integrity
- experience
- age (and that of your supporting team)
- commitment
- delegation and control

The Opportunity for Growth
- use of outside professionals
- your industry
- your company
- rate of growth — too fast?

Your Industry
- its recent performance
- its future?

Provide all the information you can, as soon as you can. Keeping your banker in the picture is the best way to get his support.

You may find the following check list an aid towards keeping your banker informed. This will in turn assist you in maintaining a good banking relationship:

- ☐ **Have a Business Plan** — discuss it with the manager regularly
- ☐ **Prepare a Cash Flow Budget** — update it monthly
- ☐ **Prepare a List of Aged Receivables and Payables**
- ☐ **Give Him Regular Financial Reports** — preferably prepared by outside accountants.
- ☐ **Tell Your Manager of Any Major Changes** — before they happen
  - new and large orders anticipated
  - plans for expansion
  - additions to premises
- ☐ **And the Bad News** — before he hears from others
  - receivables lengthening
  - inventory turns slowing down
  - payables becoming demanding
  - loss of contracts or orders
- ☐ **The Manager Can Best Help You If He Knows in Time** — a surprise is a sign that you are not running your business well.
- ☐ **Have Regular Meetings With Your Manager** — whether or not you need a loan or an increase.
- ☐ **Establish a Credit Line in Anticipation of Need Determined from Your Cash Flow** — keep your credibility. Do not let him forget you.
- ☐ **Invite Your Banker to Your Premises**.
- ☐ **Always Pay Down "Bulges"** — term loans and special loans — on time
- ☐ **If You Are Going to be Late** — discuss the problem IN ADVANCE with a suggested solution
- ☐ **Use Your Banker as an Introduction to Other Sources** — of help — of capital
- ☐ **Do Use Some of the Bank's Other Non-banking Services** — IF they fit your requirements.
- ☐ **Keep Your Own Personal Finances in Order** — you do not necessarily have to use the same bank

Every well managed business operates on a budget or financial plan prepared at least once a year. A well thought out plan aids both the businessman and the lender to evaluate the prospects of the business. The plan forces management into a realistic appraisal of the enterprise and ensures that all aspects of the company's operations are considered prior to any commitments. A plan should acquaint the businessman with potential difficulties before they develop and ensure the continuity of the business. If a business is not prepared to face financial contingencies, then the likelihood of financial problems occurring to threaten the business is high.

A banker's respect for a small businessman who performs financial planning is substantial simply because most small businesses do not adequately plan their financial operations. A plan provides the lender with a solid basis on which to judge the company and it assures the lender that management is aware of both the opportunities and potential problems. It will indicate the company's ability to maintain and repay debt or provide a satisfactory return on its investment.

ELEMENTS OF A FINANCIAL PLAN FOR LENDERS OR INVESTORS AND YOU

A. Prepare a brief summary providing:
   (1) A description of the business.
   (2) The amount of money required and what you are going to do with it.
   (3) What security you will pledge.
   (4) Summary of earnings projections.

B. Background information:
   (1) Past history of the company (should not be longer than two pages).
   (2) Provide the legal status of the company (indicate whether the business is a sole proprietorship, partnership or limited company).
   Give dates of commencement or incorporation.
   List the names and addresses of the owners and what percentage of the business they own.

C. Products and Services
   (1) Provide a description of your products and services with an assessment of their strengths and weaknesses.
   (2) Patents, trade secrets and other technical advantages.
   (3) Technologies used.
   (4) Discussion of the industry projections.

D. Management
   (1) Organization of the company.
   (2) Provide brief management biographies of key personnel (include their ages and backgrounds in this type of business).
   (3) Management compensation.

E. Marketing
   (1) Identify:
      - the total market
      - target market

- your competition (give estimates of the size of the market each competitor holds, give specific names)
- your marketing advantages relative to competitors
- your past sales and future projections
- risks
- your pricing policy
- your selling terms (credit policy)
- distribution plan

(2) Marketing strategy
- promotion plan
- methods of selling

F. Land, Buildings and Equipment
(1) Location:
- give description
- provide reason for locating where you have

(2) Provide details as to the amount of land required, site plan, costs of land and buildings, including installation of services
(3) List all machinery and equipment required
- indicate costs and installation charges
- indicate from whom and where purchases are to be made

G. Operations
(1) Work flow:
- provide diagrams if applicable
- quality control

(2) Inventory control
(3) Supplies and Materials:
- availability of supplies, costs and terms

(4) Manpower Plan:
- include informal job descriptions along with organization chart
- give salary or wage schedules

(5) Manufacturing cost estimates
(6) Operations Schedule:
- time schedule
- key events and decision points

H. References
(1) Name of bank or others with whom you have had financial dealings:
- give types of loans, terms, etc. previously held

(2) Name of accountant, lawyer or other professionals with whom you have had business relationships

I. Financial Plan
(1) List all capital requirements and sources of financing
(2) Provide profit and loss statements and balance sheets for the present and the preceding three years
(3) Provide projections, cash flow budgets, pro forma profit and loss statements, pro forma balance sheet, break-even chart (if appropriate)

J. Summary of Critical Risks and Assumptions

Supplementary exhibits can also be attached to the application including personnel resumes, community benefits, other supporting documents.

Be thorough in your written presentation. The more details supplied to support the application, the more likely it is that you will earn the lender's favor.

Some of the topics may not appear to be applicable to your business or it may prove difficult to address the subjects in a comprehensive manner. At the very least, the written presentation to lenders must satisfy them of your personal integrity and management skills. It must also show how much money you require and what you are going to do with it. Lenders have to be convinced that a loan to you will be secure and will be repaid.

A significant side benefit in performing a business plan for an investor or lender is that you will become more aware of the potential rewards and troubled areas of your business.

BUSINESS PLANNING

Only a very small percentage of the thousands of businesses started each year in Alberta are formed by financial experts. Most entrepreneurs have no special competence in finance; however, for those businesses that are sucessful, the owners have usually shown an aptitude for business planning. Accountants and advisors can help to formulate the plan, but you as the owner/manager must prepare the material and know it intimately, especially if it is to be used to obtain financing from lenders or investors.

Often firms who are experiencing rapidly increasing sales run into financial problems. The reason is that the cash flow generated by increased sales is not sufficient to pay for increased inventory, labor and other current expenses. The banker's typical response to such a situation would be, "If only you had planned for these increased expenses, it would have been easier to help you". Bankers prefer dealing with small businessmen who plan their financial needs.

START-UP COSTS

If you are starting a new business, it is advisable to begin with a comprehensive list of start-up costs. An example format is provided on the next page.

Any planned expenditures before your opening date should appear on the start-up list, while expenditures forecasted after the opening date, termed operating costs, appear on the cashflow forecast. Since we are trying to estimate the cash required to start and operate your business, DO NOT include the value of your work or equipment, tools, etc. that you already own. Start-up costs

plus the initial negative cashflows from our cashflow forecast will constitute the total amount of funds required.

The terms are as follows:

- Furniture and Fixtures — may include shelves, wall brackets, racks, tables, chairs, cabinets, etc.

- Leasehold improvements — expenditures which improve the operating site and are not removeable, for example, electrical, ventilation, partition walls, paint, carpets, etc.

- Equipment — all machinery needed in your business

- Vehicles — cars, trucks, trailers, etc.

- Security deposits — advance money is usually required on rent, utilities or leased equipment

- Legal/accounting costs — See your lawyer regarding incorporation or check on proprietorships or partnerships. You may incur legal fees to review the lease agreement or purchase contracts. An accountant may be necessary to set up your books.

- Pre-opening costs — any pre-opening expenditures to promote (catalogues, flyers, brochures, ads), train staff, obtain office supplies or travel to suppliers

- Licenses — may include federal, provincial or municipal levels of government

- Insurance — check with your insurance broker for liability, fire, life or theft coverage

- Opening inventory — Consider your inventory carefully. Buying too much or too little, the wrong type or size will cause financial problems when you open.

- Operating loan — As a rule of thumb, you can use one month of all expenses. However, this is best determined after you have done your cashflow.

START-UP COSTS

1.	Furniture and Fixtures:		
	a.	$ _____	_____
	b.	_____	_____
	c.	_____	_____
	d.	_____	_____
		Total	_____
2.	Leasehold improvements		_____
3.	Equipment		
	a.	_____	_____
	b.	_____	_____
	c.	_____	_____
	d.	_____	_____
		Total	_____
4.	Vehicles		_____
5.	Security deposits		
	a. rent	_____	_____
	b. utilities	_____	_____
	c. lease	_____	_____
		Total	_____
6.	Legal/accounting costs		_____
7.	Pre-opening costs:		
	a. advertising	_____	_____
	b. wages	_____	_____
	c. supplies	_____	_____
	d. travel	_____	_____
		Total	_____
8.	Licenses		_____
9.	Insurance		_____
10.	Opening Inventory		_____
11.	Operating loan (from cashflow)		_____
		TOTAL	═══

CASH FLOWS

The most important tool for small business management planning is a cash flow or cash budget. A cash flow is simply an estimate of when you expect to receive cash from your sales and when you expect to pay your bills.

Preparing a cash flow is often a complicated task and the first time you prepare the cash flow it will probably take some time. The second occasion will require less time and thereafter it will become routine. However, the dividends this work will pay will be considerable and allow you to make better decisions about your business.

A written cash flow allows businessmen to identify priorities for accounts payable and to schedule anticipated cash receipts. More importantly, it provides an estimate of the amount of money required to finance day-to-day operations. It also shows the lender that the business will have sufficient cash to carry loan payments on a term basis.

Planning by the use of a cash flow is a continuing activity and should be reviewed periodically to ensure accuracy. By continually reworking the cash flow, it will become indispensable to the management decision-making process.

HOW TO PREPARE A CASH FLOW

The first step in preparing a cash flow is to estimate sales on a monthly basis. Sales from previous years can be used to forecast sales for the coming year. There are many yardsticks by which a business can estimate its sales. A relatively conservative or low forecast can be used to determine the financial results of bad times. An optimistic forecast will show the strain on working capital which may result from better than expected operations. Finally the most probable sales forecast at the centre remains the anchor point about which plans are made.

Decide what amount of your sales will be cash and what amount will be credit. If last year's sales were 10% cash and 90% credit and you do not plan to change your credit policies, chances are that the same proportions will occur again this year. If you sell

on credit, take into account when you can expect to collect the accounts receivable.

Note: When preparing a cash flow, the primary concern is to keep track of cash receipts and cash expenditures. Prepare work sheets similar to those shown. When estimating future transactions, do not worry about pennies, round figures off to the nearest $10.00.

	Jan	Feb	Mar	Apr	May
Projected Sales					
Cash Sales					
Collection of last month's sales					
Collection of sales from two months ago					
Collection of sales from more than two months ago					
TOTAL CASH COLLECTION					

The next step is to plan for accounts payable on a monthly basis according to your sales projections. For example, if you pay your invoices on a 30-day basis, then the cash expenditures for January's purchases will be made in February. If you can obtain trade credit for longer terms, then cash outlays can be further delayed.

	Jan	Feb	Mar	Apr	May
Planned Purchases					
Payments on this month's purchases					
Payments on last month's purchases					
Payments on purchases from two months ago					
Payments on purchases from more than two months ago					
TOTAL CASH PAYMENTS					

Now that total cash collections and total cash payments have been estimated, make another work sheet (as shown on the next page) listing all cash transactions for the month. Remember — only list the actual cash you are expecting to receive or spend in the appropriate monthly column. An explanation of each entry is made following the form.

INCOME (CASH ONLY)

NOTE: Cash flows should be made up for an entire 12-month period.

	JANUARY		FEBRUARY	
	PLANNED	ACTUAL	PLANNED	ACTUAL
1. Cash Sales				
2. Collection from Accounts Receivable				
3. Loan Proceeds				
4. Sale of Fixed Assets				
5. Other Cash Received				
6. TOTAL CASH IN				

EXPENSES (CASH ONLY)

	JANUARY		FEBRUARY	
	PLANNED	ACTUAL	PLANNED	ACTUAL
7. Rent (for premises, equipment, etc.)				
8. Management Salaries				
9. Other Salaries and Wages				
10. Legal and Audit Fees				
11. Utilities (heat, light and water)				
12. Telephone				
13. Repairs and Maintenance				
14. Licences and Municipal Taxes				
15. Insurance				
16. Other Operating Expenses				
17. Payments of Purchase of Fixed Assets				
18. Interest paid on Loans (short-term loans, lines of credit, overdrafts)				
19. Payments on Mortgages/Term Loans				
20. Income Tax payments				
21. Cash Dividends Paid				
22. Payments on Accounts Payable				
23. Other Cash Expenses				
24. TOTAL CASH OUT				
25. SURPLUS OR DEFICIT (Subtract cash in minus cash out)				
26. OPENING CASH BALANCE				
27. CLOSING CASH BALANCE				
28. TOTAL SALES				
29. MONTH END RECEIVABLES TOTAL				

EXPLANATION

Lines (1), (2) and (22) of the cash flow have been completed by the exercise of pages 17 and 18 and their total should now be inserted on the work sheet.

line 3:	Loans — If you take possession of borrowed money during the month, list this cash receipt.
line 4:	Sale of fixed assets — if you sell a fixed asset such as a piece of office furniture or a vehicle, list this cash income in the monthly column when payment is received.
line 5:	Other cash — give all other cash income such as interest, rent, etc.
line 6:	lines 1 – 5.
lines 7 – 16:	Operating expenses — enter the amount of cheques that you write for your monthly expenses. This is actual cash outlay for the month; for example, if you write a cheque in January for the full year's insurance then the amount of the cheque would be put in the January column and nothing would be entered for the rest of the year.
line 17:	Payments on purchase of a fixed asset — if money is spent for the purchase of fixed assets such as a vehicle or a filing cabinet, list the amount for the month wnen the cheque is written.
line 18:	Interest paid on loans — this is the interest paid monthly on short-term loans such as bank overdrafts or lines of credit. Since you are in the process of working out the amount of money you will need to borrow, this interest figure may be very difficult to estimate. Consequently, you may decide to leave the line blank for now. If it is likely to be a small amount, you may decide to omit it altogether.
line 19:	Payments of mortgages/loans — indicate the monthly payment for the principal and interest on long-term loans. For example, if you borrow $3,000 to purchase a ½ ton truck and monthly payments are $100 with the first payment due in March — then $100 will be entered in line 19 for each month beginning in March.
line 20 – 21:	Income tax payments and cash dividends paid — the amounts you expect to pay, if any.
line 22:	From total cash payments on accounts payable calculated on page 18.
line 16 & 23:	Other operating expenses and other cash expenses — the expense items listed in this format may not be applicable to your business. The headings should be changed so that they are appropriate for your situation.
line 24:	Total all possible cash payments for the month.
line 25:	Surplus (or deficit) — cash in minus cash out.

line 26:	Opening cash balance is the amount of money that you started out the month with.
line 27:	Closing cash balance is the amount of money you started out with plus (or minus) the amount of cash made (or lost) in the month. The closing cash balance becomes next month's opening balance. If adding lines 25 and 26 produces a negative amount, then that is the amount that will have to be borrowed in order to make planned payments.
line 28:	Total sales — this is the amount of sales volume for the month including cash and credit sales.
line 29:	Month end receivables total — this is the amount of money owing from this month and previous months' sales. Total sales and receivable totals are not an inherent part of the cash flow although it is important to keep track of these figures for future planning.

Because this cash flow projection is to be used as an aid for planning future business needs, it is sometimes best to put it away for a few days and then study it again to see if it still makes sense when compared to last year's operation.

It is important that the cash flow is completed on an ongoing basis and is revised as the situation changes. After each month has been completed, put the actual cash flow figures next to the planned figures and compare them. If the planned figures vary considerably with the actual, it may be necessary to rethink the position of the business.

A cash flow assists in financial planning, inventory purchases and formulating credit policies. It also serves as an early indicator when expenses are getting out of line. It is one of the most important tools an owner-manager has to control his business.

BREAK EVEN ANALYSIS

Although a cash flow is probably the most important planning device available to the owner-manager, a break even analysis can be an interesting exercise to determine the profit potential and points out the necessity of controlling expenses. A break even chart is simply a visual representation of sales revenues and expenses showing their relationship to volume.

Some assumptions are normally made when performing a break even analysis. They are:

(a) Selling prices do not change.

(b) Total fixed expenses remain the same. Fixed expenses are those costs that do not change over the short run. For example: rent, equipment leases, loan repayment, etc.

(c) Variable expenses increase and decrease in direct proportion to sales. Variable expenses are those costs that can be changed in the short run. For example: part time labour, material/ inventory purchases, selling expenses, etc.

Two examples of break even analysis are shown below:

1. THE SMALL SERVICE COMPANY

Condensed Income Statement

Net Sales (60,000 units F $20 per unit)			$1,200,000
Less Costs and Expenses:	Variable	Fixed	
Direct Material	$195,000	—	
Direct layout	215,000	—	
Operational expenses	100,000	$200,000	
Selling expenses	150,000	50,000	
Rent		50,000	
General expenses	60,000	100,000	
Total	$720,000 +	$400,000 =	$1,120,000
Net profit before taxes			80,000

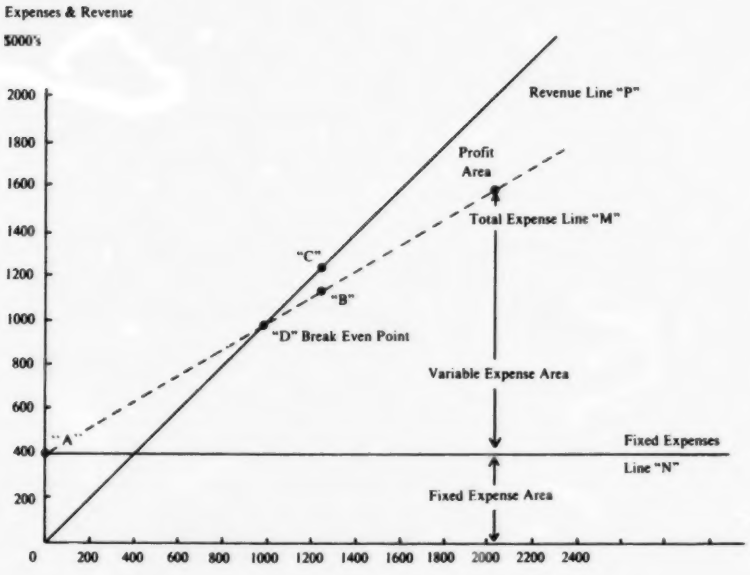
or 2. THE SMALL RETAIL COMPANY

Condensed Income Statement

Net Sales			$1,200,000
Less Costs and Expenses:	Variable	Fixed	
Cost of goods sold	$600,000	—	
Labour	100,000	$150,000	
Management	—	80,000	
Rent		100,000	
General expenses	20,000	70,000	
Total	$720,000 +	$400,000 =	$1,120,000
Net profit before taxes			80,000

Break-Even Chart Examples

1. The Small Service Company
or 2. The Small Retail Company



Sales Volume (Revenue)
$000's

Step 1: On the horizontal axis mark off a scale that represents sales volume. On the vertical axis mark off a scale representing revenue and expense items. Draw fixed expense line "N" which represents fixed expenses of $400,000 that does not change over various level of sales.

Step 2: Plot point **"B"** as determined by the total of fixed and variable expenses on the vertical axis ($1,120,000) and total sales volume on the horizontal axis ($1,200,000). Draw line "M" starting at "A" and extending through "B". Line "M" represents the total expense line. Expenses both variable and fixed at any levels of sales can be determined from it. This can be done by simply reading upward from sales volume to the total expense line "M", and then over to the vertical axis where the dollar amount of expenses can be found.

Step 3: Plot point "C" which outlines the total sales volume and total revenue or $1,200,000 on both scales. Draw revenue line "P" starting at "O" through point "C". The break-even point is at point "D" where the total expense line "M" intersects revenue line "P". Therefore, as shown on the graph, the break-even point is where sales are $1,000,000 to cover total expenses of $1,000,000.

The advantage of a break even chart is that you can readily see what level of sales are required to obtain profits. For example, according to the chart given, if sales volume totalled only $800,000, total expenses would be greater than total revenue, thereby indicating a loss. However, if sales volume amounted to $1,800,000, total revenue would be much greater than total expenses resulting in a good profit.

RATIO ANALYSIS

When discussing financing, there are a number of ratios that lenders like to use to find out the relative health of a business. Ratio analysis can also be used as a management tool for better control of the business. The basic data for ratio analysis comes from the firm's balance sheet and profit and loss statement. This data should be readily available in any business. The purpose is to detect favourable or unfavourable trends in the performance of a business. It will help a busy owner-manager identify trouble spots accurately and quickly.

Some of the key business ratios are briefly discussed below:

(a) Current Assets to Current Liabilities: This is an important test of solvency, meaning whether the cash on hand, or those short-term assets, such as inventory, which can be quickly converted into cash, are enough to meet all debts falling due within a year's time. A high current ratio is looked upon favourably.

(b) Debt to Equity: this ratio measures "what is owed compared to what is owned," thereby giving a picture of the financial soundness of a business. Total debt is divided by tangible net worth. Tangible net worth equity is the true worth of the business (assets minus liabilities) minus any intangible items in the assets, such as goodwill or incorporation costs.

(c) Net Sales to Tangible Net Worth: This ratio shows how actively invested capital is being put to work by indicating its turnover during a period. Net sales are divided by tangible net worth to arrive at the number of times the invested capital is turned over in a period. Both overworked and underworked equity is considered unhealthy.

(d) Profits to Equity: This is the measure of return on investment and is considered one of the best criteria for profitability. Net profits (after taxes) are divided by tangible net worth to arrive at a percentage figure. If this "return on capital" is too low, the capital involved might be better used elsewhere.

(e) Net Sales to Inventory: This gives the average turnover of inventory and is useful for comparing one company's performance with another, or with the industry's. Net sales are divided by the average inventory over a period of time. The turnover figure derived is only an average and should be interpreted carefully as it does not provide a good turnover control for different items within the inventory.

(f) Net Profit on Sales: This ratio measures the return on sales. Profits after taxes are divided by total sales. A high rate of return on net sales is generally viewed favourably, however, a low rate of return on sales in conjunction with rapid turnover and a large sales volume may also result in satisfactory earnings.

METHODS OF FINANCING A BUSINESS

Accounts Receivable Financing
: Obtaining a loan from a bank, factor or commercial finance company to finance day-to-day operations, on which the accounts receivable of the business are pledged as security.

Business Improvement Loans
: Government guaranteed loans within specific limits to business engaged in designated lines of endeavor.

Commercial Financing
: Borrowing funds from a factoring company against the pledge of receivables and/or inventory. The factor will attend to the collection of receivables if required. Letter of credit facilities also available.

Equipment Financing
: Borrowing from a bank, finance or acceptance company to purchase machinery or equipment, and using that equipment as collateral.

Equipment Leasing
: Obtaining the use of machinery, vehicles or other equipment on a rental basis. This avoids the need to invest capital in equipment. Ownership rests in the hands of the bank or leasing company, while the business has the actual use of it.

Floor Financing
: Usually used by car dealers, piano, furniture and large appliance dealers to finance their floor stock. The lender maintains legal ownership of the floor items while the retailer displays them for sale.

Factoring
: Selling trade accounts receivable on a non-recourse basis to a factoring company which assumes responsibility for credit and collection. Factors will advance up to 85% of approved receivables pending collection.

Inventory Financing
: Here inventory is used in two ways: to support a loan or obtain additional credit to increase inventory. In the case of a manufacturer, a bank may take a debenture or security under Section 88 of the Bank Act. If the goods are kept in a public warehouse, the bank may make advances under Section 80 of the Bank Act. Other lenders advance funds to businesses against warehouse receipts or debenture security.

Letters of Credit
: A letter of guarantee issued by a bank on behalf of its client, usually irrevocable, to a supplier guaranteeing payment if the merchandise ordered is shipped in accordance with the terms and conditions specified.

Operating Loans

Funds provided to look after the day-to-day operating requirements of a business. This type of loan is normally of a revolving nature and may be secured by receivables, inventory, a debenture or fixed (and other) assets, or other collateral.

Personal Loans

For a variety of purposes, including business-oriented situations (for example — equity participation). The borrower frequently pledges an asset as collateral for the loan.

Term Loans

Designed for a variety of capital purposes, including the purchase or repair of fixed assets and equipment. These usually run for terms up to five years and beyond. Repayment is effected in regular instalments.

Trade Credit

This is a normal form of financing employed by a business enterprise. The suppliers allow terms of credit usual to the particular trade (may be 30, 60, 90 days and beyond). A discount is often offered for payment made within 10 days; however, interest may be charged when terms are extended.

Working Capital Loans

Firms which have a heavy investment in fixed assets but have limited working capital may borrow medium to long-term funds against the security of these assets. This provides the money to meet maturing obligations, stockpile inventory and take advantage of trade discounts.

SOURCES OF FINANCING A BUSINESS

	BANKS AND TREASURY BRANCHES	VENTURE CAPITALISTS PRIVATE INVESTORS & SMALL BUSINESS EQUITY CORPORATIONS	COMMERCIAL FINANCE COMPANIES	ALBERTA OPPORTUNITY COMPANY FEDERAL BUSINESS DEVELOPMENT BANK ALBERTA AGRICULTURAL DEVELOPMENT CORPORATION ALBERTA HOME MORTGAGE CORPORATION (AHMC)	FACTORS	EQUIPMENT SUPPLIERS	TRADE SUPPLIERS	LIFE INSURANCE COMPANIES
TYPES OF FINANCING	Accounts Receivable Financing; Inventory Financing; Other Operating Loans for Capital Purposes; Fixed Assets and Equipment; Personal Loans; Factoring; Business Improvement Loans; Dept. of Regional Industrial Expansion Loans; Export Development Corporation Guaranteed Loans.	Provide debt and equity financing for all purposes.	Accounts Receivable Financing; Equipment Financing; Equipment Leasing; Floor Financing; Capital Loans; Working Capital Loans; Consolidation & Refinancing; Fixed Asset and Other Capital Loans	Equipment Financing; Fixed Asset and other Capital Loans; In some instances Working Capital Loans The Alberta Agricultural Development Corporation provides funding for agribusiness. AHMC Provides Mortgage Financing for Residential Development Companies	Accounts Receivable Financing; Letters of Credit	Equipment Financing; Equipment Leasing; Floor Financing	Trade Credit	Loans made to insurance policy holders against cash surrender values built up at comparatively low rates.
TYPE OF ORGANIZATION	Provide a wide range of commercial and personal banking services	Varies considerably	Term lender; Purchase other companies' receivables primarily balances of sales, liens and contracts; Leasing; Sales Leasebacks; On occasion provides equity financing	Operated by the Alberta and Federal Governments to provide financing assistance to new or existing business enterprises in Alberta, particularly those of a smaller size. Applicants must have a refusal from a conventional lender before proposal will be considered (except in the case of AHMC).	Handle credit and collections for manufacturers and wholesalers. Also purchases receivables on a non-recourse basis. Will advance funds pending collection and will also make advances against inventory for short periods.	Equipment manufacturers often allow small business to buy their products on the installment plan. In addition they may provide Floor Financing to their dealers and distributors. Some suppliers may be prepared to lease equipment over a reasonable period.	Suppliers normally provide a significant portion of a firm's short-term financing if a good credit record is maintained. Foreign shippers usually request letters of credit in payment or sight documentary drafts on the buyer.	Insurance companies invest money from premiums in mortgages and in bonds, short-term securities and in business enterprise.

SOURCES OF FINANCING A BUSINESS

	BANKS AND TREASURY BRANCHES	VENTURE CAPITALISTS & PRIVATE INVESTORS	COMMERCIAL FINANCE COMPANIES	ALBERTA OPPORTUNITY COMPANY FEDERAL BUSINESS DEVELOPMENT BANK	FACTORS	EQUIPMENT SUPPLIERS	TRADE SUPPLIERS	LIFE INSURANCE COMPANIES
DEGREE OF RISK ACCEPTED	MODERATE RISK	HIGH	MODERATE TO HIGH	MODERATE RISK	MODERATE TO HIGH	MODERATE TO HIGH	RELATIVELY HIGH	LOW
INTEREST RATES	MODERATE INTEREST RATES	LOW TO HIGH	MODERATE TO HIGH	MODERATE INTEREST RATES	MODERATE TO HIGH	MODERATE TO HIGH	Interest not normally charged if account paid within terms offered. Interest varying from moderate to high is sometime levied on past due accounts	LOW/MODERATE
TERMS	Repayment terms are flexible, usually related to cash flow and/or earnings	Varies considerably	Flexible, depends upon life of goods being financed	Flexible, depending on earnings and life expectancy of goods being financed	SHORT TERM	1 - 5 Years	30 - 60 days normal; dating sometimes allowed on seasonal merchandise	LONG TERM

PROVINCIAL CROWN AGENCIES AUTHORIZED TO PROVIDE FUNDS TO ALBERTA BUSINESS

ALBERTA AGRICULTURAL DEVELOPMENT
(Head Office)
4910 - 52 Street
Camrose, Alberta
T4V 2V4
Phone: 679-1311

ALBERTA HOME MORTGAGE AND
HOUSING CORPORATION

9405 - 50 Street
Edmonton, Alberta
T6B 2T4
Phone: 468-3535

2924, 11th Street N.E.
1 Deerfoot Place
Calgary, Alberta
T2E 8C4
Phone: 250-4600

ALBERTA OPPORTUNITY COMPANY
(Head Office)

P.O. Box 1860
Ponoka, Alberta
T0C 2H0
Phone: 783-4481

1275 Weber Centre
5555 Calgary Trail
Edmonton, Alberta
T6H 5P9
Phone: 427-2140

Suite 110
10333 Southport Rd. S.W.
Calgary, Alberta
T2W 3X6
Phone: 297-6437

P.O. Box 307
408 - 1st Street West
Brooks, Alberta
T0J 0J0
Phone: 362-3500

P.O. Box 2940
107A - 50th Street
Edson, Alberta
T0E 0P0
Phone: 723-6260

#304 Richmond Square Building
9804 - 100th Avenue
Grande Prairie, Alberta
T8V 0T8
Phone: 538-5220

Room 201
714 - 5th Avenue S.
Lethbridge, Alberta
T1J 0V1
Phone: 381-5474

Suite 202
Royal Bank Building
578 - 3rd Street S.E.
Medicine Hat, Alberta
T1A 0H3
Phone: 529-3594

Bag 900-23
9811 - 98 Avenue
Peace River, Alberta
T0H 2X0
Phone: 624-6387

#504 Parkland Square Bldg.
4901 - 48th Street
Red Deer, Alberta
T4N 6M4
Phone: 340-5551

Suite 200, Plaza II
4341 - 50th Avenue
P.O. Box 1990
St. Paul, Alberta
T0A 3A0
Phone: 645-6356

5014 - 48 Street
Lloydminster, Alberta
S9V 1R5
Phone 871-6490

FEDERAL CROWN AGENCIES AND OTHER FUNDING SOURCES

FEDERAL BUSINESS DEVELOPMENT BANK

Suite #606
10303 - Jasper Avenue
Edmonton, Alberta
T5J 3N6
Phone: 420-2277

3015 - 12th Street, N.E.
Calgary, Alberta
T2E 7J2
Phone: 291-4700

10135 - 101 Avenue
P.O. Box 10
Grande Prairie, Alberta
T8V 0Y4
Phone: 532-8875

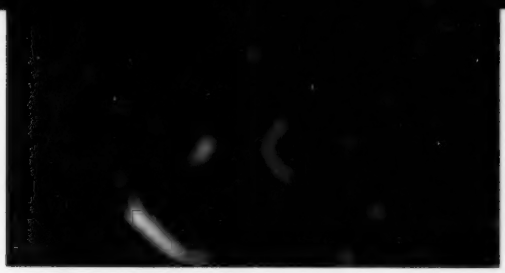
Professional Building
Suite #500
740 - 4th Avenue, S.
Lethbridge, Alberta
T1J 0N9
Phone: 328-9681

Riverside Office Plaza
Suite #100
4919 - 59th Street
Red Deer, Alberta
T4N 6C9
Phone: 343-3232

BUSINESS IMPROVEMENT LOANS
REGIONAL INDUSTRIAL EXPANSION

Suite #505
10179 - 105th Street
Edmonton, Alberta
T5J 3S3
Phone: 420-2944

Station M
Suite #630
220 - 4th Avenue, S.E.
Calgary, Alberta
T2P 3C3
Phone: 292-4575



HEAD OFFICE	12th Floor Sterling Place 9940 - 106 Street Edmonton, Alberta T5K 2P6 Phone: 427-0669
SMALL BUSINESS DIVISION	17th Floor 10025 Jasper Avenue Edmonton, Alberta T5J 3Z3 Phone: 427-3685
CALGARY	5th Floor 999 - 8 Street S.W. Calgary, Alberta T2R 1J5 Phone: 297-6284
CAMROSE	4909 - 48 Street Camrose, Alberta T4V 1L7 Phone: 679-1235
EDSON	P.O. Box 2490 Provincial Building 111 - 54 Street Edson, Alberta T0E 0P0 Phone: 723-8229
GRANDE PRAIRIE	Room 1401 Provincial Building 10320 - 99 Street Grande Prairie, Alberta T8V 6J4 Phone: 538-5230
LETHBRIDGE	Room 249 Provincial Building 200 - 5 Avenue S. Lethbridge, Alberta T1J 4C7 Phone: 381-5414
MEDICINE HAT	Room 217 Provincial Building 770 - 6 Street S.W. Medicine Hat, Alberta T1A 4J6 Phone: 529-3630
PEACE RIVER	Bag 900, Box 3 10122 - 100 Street River Drive Mall Peace River, Alberta T0H 2X0 Phone: 624-6113

RED DEER	3rd Floor Provincial Building 4920 - 51 Street Red Deer, Alberta T4N 6K8 Phone: 340-5300
ST. PAUL	P.O. Box 1688 Room 409 Provincial Building 5025 - 49 Avenue St. Paul, Alberta T0A 3A0 Phone: 645-6358